In the Supreme Court

OF THE

United States

OCTOBER TERM, 1961

No. 652

E. E. R. STARRETT and ROYAL STARRETT,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit

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[illegible]
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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1961

No.

E. E. R. SHAPIRO and RUBYE SHAPIRO,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit

E. E. R. Shapiro and Rubye Shapiro, Petitioners, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above case on September 7, 1961.

CITATION TO THE OPINIONS BELOW

The memorandum opinion of the Tax Court is unreported and is printed in Appendix A hereto, infra.

p. i. The opinion of the United States Court of Appeals for the Ninth Circuit, printed in Appendix A hereto, infra, p. v, is reported in ..... F. 2d .....

JURISDICTION

The judgment of the United States Court of Appeals was entered on September 7, 1961. (R. 188, Appendix A, infra, p. ix.) Rehearing was denied on October 13, 1961. (Appendix A, infra, p. x.) The jurisdiction of this court is invoked under 28 U.S.C. Sec. 1254(1).

QUESTIONS PRESENTED

1. Whether an accrual basis car dealer must recognize as income a contingent credit entered in his name on the books of a finance company, upon the sale and assignment by the dealer of a conditional sales contract to the finance company, when such credit is composed entirely of finance charges, and such credit and charges are subject to reduction in cases of prepayment of a conditional sales contract by the car purchaser.

2. Whether an accrual basis taxpayer must recognize as income a contingent credit entered in his name on the books of another, when by contract the terms and time of the payment or discharge of the credit is at the discretion of the other party and such discretion cannot be said to be purely ministerial.

STATUTES INVOLVED

The statutory provisions involved are sections 22(a), 22(c), 41 and 42(a) of the Internal Revenue Code of 1939. They are printed in Appendix B, infra, pp. xi-xii.

STATEMENT

On October 17, 1955, petitioners filed petitions in the Tax Court to review Notices of Deficiency sent by the respondent Commissioner. The Tax Court's jurisdiction was invoked under section 272 of the Internal Revenue Code of 1939, 26 U.S.C. 1952 Ed. The Tax Court entered its decision on April 27, 1960. Petitioners then under section 7482 of the Internal Revenue Code of 1954 petitioned the Circuit Court of Appeals for the Ninth Circuit.

Petitioners were in the business of selling used motor vehicles. Most sales were upon installment payment contracts, usually called "conditional sales contracts". During the years in question, and presently, California law requires that the component parts of the purchase price of a car bought on time be separately and distinctly labeled. That the "cash price" of the car, plus the amount of any insurance premium included in the contract and the fees of any public officer paid by seller and included in the contract, less the "down payment", constitutes the "unpaid balance". (Calif. Civil Code section 2981, Appendix C, infra, p. xv.) The addition to the cash price by reason of payment being made over a period of time is called "time price differential". The "time price differential" plus the "unpaid balance" constitutes

the "contract balance". (Calif. Civil Code section 2981, Appendix C, infra, p. xv.)

Petitioners sold almost all the contracts so acquired, together with the vehicles therein described, to Pacific Finance Co., which paid by voucher check the entire "unpaid balance" shown by the contract. Pacific Finance Co. handled the "time price differential" provided for in the conditional sales contract purchased from the petitioners by recording on its books $7.50 as an administrative charge. A portion of the time price differential was credited Pacific Finance Company's own unearned interest account, and the excess was credited to the reserve account in petitioners' names. (R. 151.)

As a matter of company policy, in the event of prepayment of the conditional sales contract, the finance company would not charge the full time price differential. In such instances, the finance company would charge to, that is, deduct from, the dealer's reserve account a sum equal to the dealer's share of the uncollected time price differential. The Circuit Court stated that this procedure was an implied in fact term of the agreement between petitioners and Pacific Finance Co. (R. 188b, ____ F. 2d ____, Appendix A, infra, p. vii.) The credits to the reserve account were derived solely from finance charges. The only charges shown by the record are: if there was a default by a car purchaser, Pacific would charge the reserve for the portion of the unearned and uncollected time price differential on the contract that had originally been credited to the reserve (R. 133-

134); other charges to the reserve account were to correct errors and mistakes, insurance adjustments, and for payments to the dealer. (R. 152.)

The testimony in the Tax Court was to the effect that Pacific would be reluctant to ever offset the petitioners' financial obligation to Pacific arising from Pacific's out-of-pocket losses on defaults and repossessions on conditional sales contracts guaranteed by the petitioners by charges to the dealer's reserve. (R. 133-4.) If and when all contracts purchased by Pacific from the petitioners were paid in full, and if there were no other obligations of petitioners to Pacific, the petitioners would be entitled to any balance in the reserve account. (R. 155.) Until such occurrence, payments from the dealer's reserve were at Pacific's discretion. (R. 124, 153.) In deciding whether or not to make payments, Pacific considered primarily the aging of the contracts, that is, the collection record of the contracts. The personal and business situation of the petitioners was also an important factor. (R. 153.) The petitioners frequently requested that Pacific pay them money, to be charged against the dealer's reserve account. Pacific turned them down almost every time. (R. 124, 153.)

The Tax Court has held that the petitioners were on an accrual basis of accounting. (R. 157.)

REASONS FOR GRANTING THE WRIT

1. The California State Board of Equalization licenses over 5,990 automobile dealers whose sales for

the fiscal year ending June 1960 exceeded $3,143,000,000 or slightly over 1/12 of the total national auto and truck sales for that period. The issue herein is of vital importance to each of these dealers as well as to all dealers in other states having laws similar to Section 2982, subdivision D, California Civil Code (Appendix C, infra, p. xix), which requires a refund credit of a portion of the time price differential upon prepayment before maturity of automobile purchase contracts. It also affects all dealers who contract, as in the instant case, with financial institutions that voluntarily give such credits though not required by law.

As the Circuit Court stated in the instant case (..... F. 2d ....., Appendix A, p. vii), there is no difference between the situation where the finance company is compelled by statute to reduce the time price differential in the event of prepayment of the contract and the situation where by agreement between the dealer and the finance company the finance company may adjust the finance reserve in the event of prepayment and charge a portion of the adjustment to the dealer's reserve. In either case the dealer has no legal right to the amount charged against him. In one case the reason is statutory, in the other it is contractual.

Petitioners have been unable to find published figures stating the face value of the conditional sales contracts sold by California automobile dealers. Similarly, they have been unable to find figures for states with comparable laws, or figures stating what dollar

amounts of all conditional sales contracts sold are represented by finance charges.

However, according to the Federal Reserve Bulletin of December 1961, pages 1456 to 1457, on December 31, 1960, the total amount for the nation of outstanding installment credit paper on automobiles was $17,444,000,000. At the same date, the total outstanding amount of installment paper on automobiles purchased and held by banks, sales finance companies and all other financial institutions was $14,265,000,000.

A report entitled Consumers' Installment Credit, made by the Board of Governors of the Federal Reserve Board, was published in 1957 in 4 parts and 6 volumes. According to this study, the total outstanding installment credit arising from sales of new and used automobiles at the end of 1955 was 13.5 billion dollars. (Id. p. 28.) The annual finance charge in 1956 was 6% for new cars, 8½% on late model used cars, and 12% on older models. (Id. p. 53.)

Typically, the dealer's share in early 1956 was 1/5 to 1/3 of the total finance charge. (Id. p. 55.) Trade sources indicated that the average in 1955 was 25% of the finance charges. (Id. p. 59.)

A rough estimate, therefore, of the new and used car time price differential that is annually credited dealers' reserve accounts for California alone would be $17,000,000.[1]

[1]This estimate uses 1960 as the base year and assumes that the amount of installment credit outstanding in the hands of sales banks and other financial institutions at the end of the year approximates the total amount of installment credit purchased by

2. The number of car dealers concerned and the large amount of money involved has resulted in continued litigation of this particular point in recent months and the decision of this court in *Commissioner v. Hanson*, 360 U.S. 446, 79 S. Ct. 1270, has not terminated the litigation. See *Dalton & Ely Motor Co., Inc. v. U. S.*, D.C. Ky., July 10, 1961, ___ Fed. Sup. ___, 8 AFTR (2) 5186 (Appendix D, infra, p. xxi), *Smith Motors, Inc. v. U. S.*, D.C. Ver., Aug. 9, 1961, ___ Fed. Sup. ___, 8 AFTR 336 (Appendix D, infra, p. xxvi). Other cases on this point are *Wiley v. Commissioner* (6th Circuit 1959), 266 F. 2d 48; *Morgan v. Commissioner* (9th Circuit 1960), 277 F. 2d 152; *General Gas Corp. v. Commissioner* (5th Circuit 1961), 293 F. 2d 35; *Ellis A. Hummel* PHTC Memo 61034; *Krell Buick, Inc. v. Ridell*, D.C. Calif., Apr. 1960, ___ Fed. Sup. ___, 5 AFTR 1417.

3. The instant case involves more addition to income than the total of all the litigated cases for the first 15 or 20 years after the Commissioner commenced litigating this issue.

4. There is a conflict between the District Court cases of *Dalton & Ely Motor Co.* (supra) and *Smith Motor Co., Inc.* (supra) and the Circuit Court cases of *Wiley* (supra) in the 6th Circuit and the cases of

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those institutions during the year. The estimate also assumes that since California sells 1/12 of the dollar volume of cars sold each year that 1/12 of the paper sold and outstanding relates to California dealers. The estimate also assumes that the annual finance charge is 6% and that dealers still get 1/3 of the total finance charges.

Morgan (supra) and *Shapiro* (Appendix A, infra, p. vi) in the 9th Circuit.

In *Wiley v. Commissioner* (6th Circuit, 1959), 266 F. 2d 48, the sources and formula for establishment of the reserve as well as the purpose and the respective rights thereto as between dealer and finance company, was expressly provided by contract. Time of payment was fixed by formula with no discretion vested in the finance company, which clearly distinguishes it from the instant case, since even those credits which were discretionary with the finance company having been made became fixed as to the dealer's right thereto and had to either be paid to the dealer or credited to his obligations.

The Circuit Court case of *Morgan* (9th Cir. 1960), 277 F. (2) 152 merely cited *Wiley* (supra) and used the string citation approach without discussing the case. In the instant case the 9th Circuit disregarded the express reservation of the question in *Hansen* (1959), 360 U.S. 446, 79 S. Ct. 1270, of whether or not different treatment should be accorded to dealers' reserves composed of finance charges and merely cited *Hansen* (supra) and *Morgan* (supra). Petitioners admit that the District Court cases cited in Appendix D, infra, pp. xxi, xxvi, leave much to be desired also, in that they too did not discuss just what it is that goes to determine whether or not a right to income has become fixed. In light of the lack of a clear, complete and decisive ruling on this issue, it is submitted that taxpayers will continue to litigate this question until the Supreme Court finally makes a decision as to this issue.

Petitioners submit that the fact situation in time price differential cases, meaning by that phrase, time price differential plus legal obligation to reduce the time price differential in case of prepayments, can be precisely analyzed to show that as a rule of law there is no fixed right to income. It is petitioners' contention that if as a matter of contractual agreement an accrual basis promisee's right to payment from his promisor is conditioned upon payment to his promisor by a third party, then until the third party pays the promisor, the promisee does not as a matter of law have a fixed right to payment and should not accrue. Petitioners refer the court to the cases of *Lancaster v. Commissioner,* 11 CCH Tax Court Memo 1108 (1952); *Cassatt v. Commissioner,* 137 F. 2d 745 (3 CCA 1943); *Motion Picture Corp. v. Commissioner,* 11 P-H B.T.A. Memo 261 (1942); and *Roberts Island Dredging and Improvement Co. v. Commissioner,* 1942 Prentice Hall Memo, Decisions, Volume 11, 42. 498.

In *Lancaster,* the Tax Court found that the taxpayer, a subcontractor, under his contract with the prime contractor was entitled to receive payment only from the prime contractor and that under the contract the prime contractor was not required to pay the taxpayer until the prime contractor was paid by the owner of the property. The Court held that since the taxpayer would not have a legally enforceable right to payment until the prime contractor was paid by the owner the taxpayer did not have to accrue as income his right to payment until the prime contractor was actually paid.

In *Motion Picture*, the taxpayer, a distributor, did not have to accrue the right to receive from another corporation a stated percentage of the film rentals to be paid to the other corporation in the future by exhibitors. The court held that the payment by the exhibitors to the other corporation was a condition precedent to accrual by the taxpayer. In that case the right to a specified percentage and the obligation to pay it were contractual.

In *Cassatt* a stock brokerage firm took over the accounts of another firm agreeing to pay to the selling firm 25% of commissions received for a period of six years from sales of securities to the customers taken over. It was held that this right did not have to be accrued as income by the selling firm in the year of the sale of the business.

In the instant case, Pacific would never pay the petitioners any part of the dealer's reserve unless Pacific itself had first collected such a sum from the car purchaser, so that if any time price differential was lost, whether by prepayment or by loss of unpaid time price differential on defaulting contracts, Pacific would merely reduce that contingent credit called reserve account. The substance of the contract between the dealer and the finance company in the instant type of situation is identical to the situation where the assignee of a discounted note has agreed as part of the purchase price to pay assignor part of each payment of interest in the future as collected by him. It is clear that neither the assignor nor the assignee has the fixed right to such interest until such interest

is due and payable, that is, earned. This distinction between interest and time charge is important from the standpoint of avoiding conflict with usury laws, but has little economic significance. Consumers Installment Credit, volume 1, part 1, page 49.

For accrual basis taxpayers, the earning of the interest or time-price differential constitutes the final event which makes the right to income a fixed right.

Petitioners are of the opinion that the condition or implied in fact term of the contract between Pacific and the petitioners is common to all dealers' finance institution arrangements, including the one in *Hansen* (1959), 360 U.S. 446, 79 S. Ct. 1270. If this were the only way that dealers' reserves could ever be reduced, then as a matter of law there would be no fixed right to income until the finance institution collected those sums represented by the dealers' reserve from day to day.

The difference between this case and *Hansen* (supra) is that in *Hansen* the dealers' reserves were also charged for obligations of the dealer to the financial institution, that is, the dealers' reserve, instead of being treated for the inaccurate shorthand statement of affairs between the dealer and the financial institution it is, was treated as a real, fixed right belonging to the dealer of such present economic substance that it would be reasonable to use it to offset the out-of-pocket losses suffered by finance institutions because of default on contracts that the dealer had already been paid for and had guaranteed.

In the instant case, the record does not show that the dealers' reserve was ever used to replace such financial obligations of the petitioners, but more significant, in terms of the generality of this case, the record does show that if this would ever be done it would only be done after the finance company had actually collected enough money in the way of time price differential from car purchasers so that it would not be substituting an out-of-till loss of its own by the elimination of a contingent or unmatured debt of its own.

Once the finance company collects such time price differential, however, its obligation, disregarding for the moment petitioners' alternative argument raised in the second question presented, does mature and the dealer does have a fixed right so the finance company would be reasonable in using these collections to offset the dealer's obligation to it. That is, by the time a finance institution would use dealers' reserves to offset the dealer's obligation to it, the dealer's right to the reserve has matured, at least to the extent of the offset.

5. The second question presented in the case is an alternative argument which has not received due consideration by the courts below in the instant case. Typical is the Circuit Court approach, which treated the case as being a dealers' reserve case and *Hansen* (1959), 360 U.S. 446, 79 S. Ct. 1270, as being the last word in dealers' reserve cases, no matter what might be the peculiarities of each contractual relationship. It is necessary that the Supreme Court correct those

lower courts which assumed that all dealers' reserve cases are identical. The question presented is perhaps not common to any one type of business transaction, but the principle involved is of extreme importance since it raised a question which was of basic importance to accrual accounting.

It is true, as stated in the *Hansen* case, that for accrual basis taxpayers it is the time of acquisition of the fixed right to receive income and not the time of actual receipt that determines whether or not income has accrued and is taxable. However, this does not state the whole picture for accrual basis taxpayers. For it is also true that in spite of the fact that the right to income has become fixed, if the time and terms of payment are completely at the discretion of the debtor, then in order to properly recognize income, accrual basis creditors are allowed to recognize income only upon actual receipt. See *Long Poultry Farms Inc. v. Commissioner,* 249 F. 2d 726 (4 CCA 1957), and *San Francisco Stevedoring Co. v. Commissioner,* 8 T.C. 222 (1947).

In *Masonite Corp. v. Fly,* D.C. Miss., Apr. 4, 1961, ... Fed. Sup. ...., 7 AFTR 2d, 1149, application for a state income tax refund was based on renegotiation of profits for a prior year had with the federal government. The commissioner determined the refund was taxable in the year renegotiation was consummated. Plaintiff claimed it was taxable in the subsequent year when allowance of the claim by the state tax commission was approved by the attorney general. The authority of the attorney general was not

ministerial but discretionary, not a formality but required examination of the merits and an opinion as to legality. In the face of such possibilities, the court held *Masonite* did not have to assume ultimate allowance of its claim was inevitable and accrual was not required prior thereto.

In *Long Poultry* (supra) the taxpayer, who was on an accrual basis, received a patronage refund credit on the books of a cooperative. The court held that the credit was not accruable because it was merely a conditional credit subject to diminution if there were losses, it was subordinated to the debts of the cooperative and payable only after prior credits over a 9-year period were satisfied, and then only if and when the cooperative should decide.

In *San Francisco Stevedoring* (supra), the taxpayer, who was on an accrual basis, received the right to receive a specified amount but the date of payment of the amount was up to the discretion of the officers of the association. It was held that this contingency prevented accrual of income.

The principle petitioners draw from these cases is that where the right of a promisee to receive money either as to amount or as to date of payment is by contract, whether express or implied in fact, subject to the unilateral discretion of the promisor, the contingency is such that the right need not be accrued as income.

The policy behind this is that an accrual basis taxpayer whose legal rights are so flimsy should not be

forced to recognize as income receipts which may come to him at some indeterminable time in the future beyond his control.

CONCLUSION

The questions presented concerning proper tax accounting in relation to sales finance charges pervade the entire field of consumer installment credit and have national impact and importance. Already of vital importance to the automobile business, which supplies almost 50% of the total of such credit, it also, as disclosed by litigated cases, affects contracts arising from all types of installment purchases of consumer durable goods, such as furniture, mobile homes and trailers, pleasure boats, and even some home financing, and the trend for 50 years has shown a constant increase both as to dollar volume and types of items affected.

The fiction to avoid usury laws of "carrying charges", "time price differential", and similar terms, requires an analysis in its true light and economic significance as interest. The true nature of installment purchase contracts which are in reality a cash price plus additions, with the passage of time requires a clear and definite legal interpretation for tax accounting purposes.

Until this is done, the multitudinous variations of sales finance company and financial institution dealer arrangements of the past 30 years will continue, each with an idea of avoiding the impact of the most recent

decisions and litigation will continue to result in every jurisdiction of the country.

For the foregoing reasons, the petition for writ of certiorari ought to be granted.

Dated, San Francisco, California,
January 8, 1962.

Respectfully submitted,
CONRAD T. HUBNER,
Attorney for Petitioners.

(Appendices A, B, C and D Follow.)

Appendices.

Appendix A

OPINION OF THE TAX COURT OF THE UNITED STATES

LeMire, Judge:

The petitioner was a retail used car dealer who maintained inventories. He was on an accrual basis of accounting and reporting income. Charles M. Kilborn, 29 T. C. 102. The petitioner sold automobiles on credit. Conditional sales contracts covering these dealings showed the cash selling price; from this was deducted the "down payment" to arrive at the "amount unpaid on cash price"; to this was added the cost of insurance premiums, registration and title fees to reach the "unpaid balance," to this there was added a "time price dfferential." This was any figure to which the petitioner could get the customer to agree. The sum of the last two items was the "total contract balance due from seller." These contracts were sold to Pacific Finance Company. When Pacific bought these contracts it would pay the petitioner the "unpaid balance" in cash. The difference between the amount of cash and the "total contract balance due from seller" was the so-called "time price differential." This was allocated to a $7.50 credit to Pacific as a charge for handling; a credit of a percentage rate of interest on the "unpaid balance" (discount) to Pacific as unearned income; and the remainder as a credit to the petitioner's "dealer reserve account" on Pacific's books.

This reserve supported the petitioner's guaranty of the contract payments and other liabilities which it had to Pacific. It was thus, on crediting, used for

the petitioner's benefit in accordance with the petitioner's own agreement. The dealer reserve was paid to the petitioner, in part, when, in the judgment of Pacific, it was larger than necessary to meet the requirements of the guaranty. The petitioner eventually was entitled to any balance in the reserve, subject to liabilities to Pacific.

The amounts credited to the petitioner's "dealer reserve account" are accruable and taxable to him in the year in which they were credited. They are part of the full price for which the petitioner sold the automobiles.

The Supreme Court recently affirmed the Tax Court's view that comparable dealer reserve arrangements gave the dealers a fixed right to receive albeit in a later year, the amounts credited to their reserve accounts; that these credits belonged to the dealers subject only to their pledge as collateral security in accordance with the agreements between the dealer and the finance company; and that they were accruable and taxable to the dealers in the year of crediting. Commissioner v. Hansen, ... U.S. ..... (1959), reversing 258 F 2d 585, reversing on this issue a Memorandum Opinion of this Court; Commissioner v. Glover, ... U.S. ....., (1959), reversing 253 F. 2d 735, reversing a Memorandum Opinion of this Court; and Baird v. Commissioner, ... U.S. ..... (1959), affirming 256 F. 2d 918, affirming a Memorandum Opinion of this Court.

The petitioner argues that there is no "withhold" by Pacific in issue in the present case. He is right

in the sense that Pacific held back in its payment for the conditional sales contracts no amount from what would have been the price if the car was sold for cash. Here the "dealer's reserve" in question was derived from the "time price differential," but it is not clear that it was not in reality the same thing and not a participation in the interest, as such, to be collected. The Supreme Court did not find the facts sufficient in the cases before them to pass upon the issue of whether the arrangements there were a reserve related to interest due in the future. However, this Court, since its earliest "dealer reserve" case of Shoemaker-Nash, Inc., 41 B.T.A. 417, has held that dealer reserves which were formed from a part of the carrying or finance charge, as distinguished from the cash price paid for the contract, were accruable as income when credited to the dealer reserves. To the same effect see, also, Albert M. Brodsky, 27 T.C. 216; Arthur V. Morgan, 29 T.C. 63, and Wiley v. Commissioner, 266 F. 2d 48, affirming a Memorandum Opinion of this Court. Arthur V. Morgan, supra, like the petitioner here, was a car dealer in California. The transactions were strikingly similar situations. We said:

> We do not agree with the petitioners that the arrangement between the partnership and the bank was in the nature of a joint venture in which each was to share in the time-price differential as it was "earned." Actually the bank was making a specific charge and its income from the transaction was limited to that amount. As we view the relationship

between the partnership and the bank, the bank undertook an obligation to satisfy the full amount of the contract balance, less its discount consisting of its specific charge and a percentage of the total contract balance. * * *

See also Edward C. Cadjew, ... T.C. decided this day.

This issue is decided for the Commissioner.

The Commissioner has also included in the petitioner's income for 1945, 1946 and 1947 cash payments which he received in those years on account of the accumulated balance in the petitioner's dealer's reserve account on the books of Pacific on December 31, 1944. The Commissioner's theory is that an accrual basis is the only proper method for determining the petitioner's income from the automobile business, that the credits representing these cash payments in the years in question were not accrued and taken into income in the prior years, and, therefore, should be included in 1945, and 1946 and 1947 when they were received in cash. The Commissioner at the hearing expressed the belief that his position was contrary to the holdings of this Court on similar situations. He was right. See, e.g., Estate of Samuel Mnookin, 12 T.C. 744, affd. 184 F. 2d 89; Commissioner v. Dwyer, 203 F. 2d 522, affirming a Memorandum Opinion of this Court.

Decisions will be entered under Rule 50.

Filed July 24, 1959.

Served July 24, 1959.

OPINION OF THE UNITED STATES COURT OF APPEALS

United States Court of Appeals
for the Ninth Circuit

E. E. R. Shapiro and Rubye Shapiro,
Petitioners,
vs.
Commissioner of Internal Revenue,
Respondent.

No. 17,136
Sept. 7, 1961

Upon Petition to Review a Decision of the
Tax Court of the United States

Before: Orr, Jertberg and Merrill, Circuit Judges

Merrill, Circuit Judge

Taxpayers, husband and wife, have petitioned for review of a tax court decision sustaining deficiencies in income for the years 1945 to 1948, plus penalties. Since the amounts in dispute result from business dealings of the husband, we shall, in discussing the problem, refer to him as though he were the sole taxpayer.

During the years in question, taxpayer was engaged in business in San Francisco as a dealer in used automobiles. The financing of time sales was accomplished by arrangement with Pacific Finance Company, by which that company accepted taxpayer's conditional sales contracts, paying taxpayer a sum

equal to the unpaid balance of the purchase price. On time sales an additional sum covering interest and service charges and termed "time-price-differential" was charged to the purchaser as an addition to the purchase price. Pacific Finance, upon accepting a conditional sales contract, assigned a portion of the time-price-differential to a dealer's reserve, maintained for taxpayer as security for the discharge by taxpayer of all direct or contingent liabilities owing by him to Pacific through their course of dealing. From time to time, as this reserve exceeded what Pacific regarded as a necessary security level, payments from the reserve were made to taxpayer.

Taxpayer reported his income upon the accrual basis. As to the dealer's reserve, he reported only that portion actually paid to him, contending that his right thereto did not accrue until such payment. It is as to the sum maintained in the reserve that this dispute is concerned. The commissioner contends that the taxpayer's right to such sum accrued when it was credited to the reserve, irrespective of when payments were made to taxpayer by Pacific.

In Commissioner vs. Hansen, 1958, 360 U.S. 446, the Supreme Court held that sums credited to a dealer's reserve were taxable to an accrual system taxpayer irrespective of the date of actual payment. The reserves in that case were created by withholding from the dealer portions of the purchase price.

This court in Morgan vs. Commissioner, 9 Cir., 1960, 277 F.2d 152, following Wiley vs. Commissioner, 6 Cir., 1959, 266 F.2d 48, held that the ruling in

Hansen applied to a reserve created from time-price differential credits as well as to one created from withheld purchase price.

We regard these cases as controlling here.

Taxpayer protests that in two respects events subsequent to the crediting of the reserve could adversely affect his interest therein.

First. The prepayment of the contract by the purchaser could, under Pacific's practice, result in a proportionate reduction of the time-price-differential chargeable to the purchaser and a debit against that portion of that time-price-differential which had been theretofore assigned by Pacific to the taxpayer's dealer's reserve. Morgan vs. Commissioner, supra, held that this circumstance did not affect the taxability of the reserve. In Morgan the purchaser's right to reduction in the event of prepayment was conferred by statute. Taxpayer contends that since there was here no statutory right to reduction, Morgan is distinguishable from the instant case. The reduction here was, however, granted by Pacific pursuant to its established policy, which, we assume, was known to taxpayer and assented to by him as an integral part of the arrangement under which he was dealing with Pacific. Accordingly, we regard Morgan as controlling upon this point.

Second. In the event of a default by the purchaser, the dealer's reserve was proportionately debited. Such was true, however, in both the Hansen and the Morgan cases.

Finally, taxpayers contend that this case is distinguishable from Hansen and Morgan in that here Pacific Finance reserved to itself full discretion as to when payments from the dealer's reserve were to be made to taxpayer; that this fact rendered it impossible to place a fair market value upon taxpayers' right to the reserve.

It is clear that when the reserve exceeded the amount of taxpayers' liabilities, direct and contingent, the excess was payable. Whether any payments were otherwise to be made depended upon Pacific's appraisal of all pertinent security factors. The reserve thus served as the equivalent of a cash bond for the performance by taxpayer of his monetary obligations. If there was uncertainty as to the time when taxpayer was entitled to payment, it resulted not from any question as to his right to the reserve but from the existence of counterbalancing direct and contingent liabilities. In our judgment, then, this case is not distinguishable.

Affirmed.

(Endorsed) Opinion Filed Sept. 7, 1961.

Frank H. Schmid, Clerk.

JUDGMENT OF THE UNITED STATES COURT OF APPEALS

United States Court of Appeals
for the Ninth Circuit

E. E. R. Shapiro, et al.,
Petitioners,
vs.
Commissioner of Int. Revenue,
Respondent.
No. 17136

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered Sept. 7, 1961

United States Court of Appeals for the Ninth Circuit
Excerpt from Proceedings of Thursday,
October 13, 1961

Before: Orr, Jertberg and Merrill, Circuit Judges

ORDER DENYING PETITION FOR REHEARING

On consideration thereof and by direction of the Court, It Is Ordered that the petition of the petitioner filed October 6, 1961, and within the time allowed therefor by rule of court for a rehearing of above cause be and hereby is, denied.

Appendix B

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22 GROSS INCOME.

(a). *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid; or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may

be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22(c).

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.41-1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of in-

come and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items or gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commisisoner clearly reflects it.

SEC. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consisteney. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period.

But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22 (c)-5.)

* * * * *

SEC. 29.41-3. *Methods of Accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and section 29.54-1.) Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and sections 29.22(c)-1 to 29.22(c)-8, inclusive); * * *.

* * * * *

Appendix C

PERTINENT SECTIONS OF CALIFORNIA CIVIL CODE

§ 2981. *Definitions*

As used in this section and in Section 2982 of the Civil Code, unless the context otherwise requires:

(a) "Conditional sale contract" shall mean:

1. Any contract for the sale of a motor vehicle, with or without accessories, under which possession is delivered to the buyer but the title vests in the buyer thereafter only upon the payment of all or part of the price, or upon the performance of any other condition.

2. Any contract for the bailment or leasing of a motor vehicle with or without accessories, by which the bailee or lessee agrees to pay as compensation a sum substantially equivalent to the value of the property, and by which if is agreed that the bailee or lessee is bound to become, or has the option of becoming, the owner of the property upon full compliance with the terms of the contract.

3. Any contract for the sale of a motor vehicle, with or without accessories, under which possession is delivered to the buyer, and a lien on the property is to vest in the seller as security for the payment of part or all of the price, or for the performance of any other condition.

(b) "Seller" shall mean the person who sells or leases the property under a conditional sale contract.

(c) "Buyer" shall mean the person who buys or hires property under a conditional sale contract, or any legal successor in interest of such person.

(d) "Person" shall mean and include an individual, company, firm, association, partnership, trust, corporation, or other legal entity.

(e) *"Cash price" shall mean the amount for which the seller would sell and transfer to the buyer unqualified title to the personal property described in the conditional sale contract, if such property were sold for cash at the seller's place of business on the date such contract is executed, and includes any applicable sales taxes.*

(f) *"Down payment" shall mean that part of the cash price which the buyer pays or agrees to pay to the seller in cash or property value or money's worth at or prior to delivery by the seller to the buyer of the personal property described in the conditional sale contract.*

(g) *"Unpaid balance" shall mean the difference between (e) and (f), plus all insurance premiums, and all fees paid or to be paid to any public officer, in connection with the transaction, which are included in the contract balance.*

(h) *"Time price differential" shall mean any amount which the buyer agrees to pay to the seller in excess of the unpaid balance.*

(i) *"Contract balance" shall mean the amount unpaid under the conditional sale contract, which the buyer agrees to pay in installments as provided therein.*

(j) "Motor vehicle" shall mean any vehicle required to be registered under the Vehicle Code. (Added Stats. 1945, c. 1030, p. 1991, § 1.)

(Emphasis added.)

§2982. *Motor vehicles.*

(a) Contents; formalities. Every conditional sale contract for the sale of a motor vehicle, with or without accessories, shall be in writing and shall contain all of the agreements between the buyer and the seller relating to the personal property described therein. It shall be signed by the buyer or his authorized representative and by the seller or its authorized representative, and when so executed an exact copy thereof shall be delivered by the seller to the buyer at the time of its execution. It shall recite the following separate items as such, in the following order:

1. The cash price of the personal property described in the conditional sale contract.

2. The amount of the buyer's down payment, and whether made in cash or represented by the net agreed value of described property traded in, or both, together with a statement of the respective amounts credited for cash and for such property. As soon as received by the dealer the dealer shall refund to the buyer or credit to the buyer on the next payment due the amount realized on any insurance policy, or rights thereunder, assigned to the seller by the buyer in connection with the conditional sale. Failure of the dealer to comply with the foregoing provision shall in no way affect the validity or enforceability of the conditional sale contract.

3. The amount unpaid on the cash price, which is the difference between Items 1 and 2.

4. The cost to the buyer of any insurance, the premium for which is included in the contract balance.

5. A description and itemization of amounts, if any, which will actually be paid by the seller or his assignee to any public officer as fees in connection with the transaction, which are included in the contract balance.

6. The amount of the unpaid balance, which is the sum of Items 3, 4, and 5.

7. The amount of the time price differential.

8. The contract balance owed by the buyer to the seller, which is the sum of Items 6 and 7.

9. The number of installments required to pay the contract balance, the amount of each installment, and the date for payment of the installments.

(b) Insurance. If any charge for insurance is included in the amount paid or to be paid by the buyer under any conditional sale contract for the sale of a motor vehicle, with or without accessories, an insurance policy or policies or a certificate of insurance under a master policy shall be issued and the seller shall within 30 days after the execution of the conditional sale contract send or cause to be sent to the buyer the original or an exact copy of such policy or policies or certificate.

(c) Time price differential; limit. The amount of the time price differential in any conditional sale con-

tract for the sale of a motor vehicle, with or without accessories, shall not exceed 1 percent of the unpaid balance multiplied by the number of months, including any excess fraction thereof as one month, elapsing between the date of such contract and the due date of the last installment, or twenty-five dollars ($25), whichever is greater, provided that such contract may provide for interest on any delinquent installment from and after the date of delinquency, and for reasonable collection costs and fees in the event of delinquency.

(d) Payment before maturity; refund credit. Any provision in any conditional sale contract for the sale of a motor vehicle to the contrary notwithstanding, the buyer may satisfy in full the indebtedness evidenced by such contract at any time before the final maturity thereof, and in so satisfying such indebtedness shall receive a refund credit thereon for such anticipation of payments. The amount of such refund shall represent at least as great a proportion of the time price differential, after first deducting from such time price differential a minimum charge of not to exceed twenty-five dollars ($25), as the sum of the periodic time balances after the month in which such contract is paid in full bears to the sum of all of the periodic time balances under the schedule of payments in the contract, both sums to be determined according to the monthly balances which would result if the indebtedness were paid according to the terms of the contract; provided, however, that the provisions of this subsection shall not impair the right of

the seller or his assignee to receive a minimum time price differential of twenty-five dollars ($25), or to receive interest on delinquent installments or reasonable collection costs and fees, as provided in subsection (c) of this section; and provided further, that where the amount of such refund credit would be less than one dollar ($1), no refund need be made.

(e) Seller's deliberate violation; buyer's rights. If the seller, except as the result of an accidental or bona fide error in computation, shall violate any provision of subdivisions (c), or (d) of this section the conditional sale contract shall not be enforceable, except by a bona fide purchaser for value, and the buyer may recover from the seller in a civil action the total amount paid on the contract balance by the buyer to the seller or his assignee pursuant to the terms of such contract.

(f) Contract holder's violation; buyer's rights. If the holder of such contract, except as the result of an accidental or bona fide error in computation, shall violate any provision of subdivision (d) of this section, the buyer may recover from such holder in a civil action the total amount paid on the contract balance by the buyer to such holder pursuant to the terms of such contract. (Added Stats.1945, c. 1030, p. 1992, § 2. As amended Stats.1949, c. 1594, p. 2842, § 1; Stats.1951, c. 342, p. 776, § 2.)

(Emphasis added.)

Appendix D

RECENT PERTINENT DECISIONS OF LOWER COURTS

Dalton & Ely Motor Company, Inc., Plaintiff,

v.

U.S., Defendant.

U.S. District Court, E. Dist. of Ky., at London, No. 963, July 10, 1961.

Years 1955-1956. Decision for taxpayer.

1. *Tax accounting—Time for reporting income.*

Automobile dealer was not required to accrue that part of bank's collections of finance charges which bank credited to reserve account for dealer. Dealer did not acquire fixed right to money. The dealer-taxpayer, upon making a car sale, took a negotiable promissory note from the customer for the unpaid balance plus a finance charge. The note was endorsed to a bank which paid taxpayer the purchase price of the car. As installment payments were collected, the bank kept part of the finance charge and credited the remaining part thereof to taxpayer's account. None of this money was to be turned over to taxpayer until the account reached $30,000, and the bank would charge against the account any losses sustained by it on the paper taken from taxpayer's customers. Since the account never reached $30,000, taxpayer never acquired a fixed right to the money and none of it was income. *References:* 1961 P-H Fed. ¶ 6057(10); 6110; 6123(30).

Robert J. Watson, 1911½ Cumberland Ave., Middlesboro, Ky., Atty.-for Plaintiff.

Jean L. Auxier, U.S. Atty., Lexington, Ky., for Defendant.

FORD, District Judge:

This cause came on regularly for trial before the court sitting without a jury on April 18, 1961, with Robert J. Watson, Middlesboro, Ky., appearing as attorney for plaintiff, and Hon. Herbert L. Awe, Washington, D.C., and Hon. Jean L. Auxier, Lexington, Ky., appearing as attorneys for defendant. The court having heard the testimony and having examined the proofs offered by the respective parties, and the court being fully advised in the premises, makes the following findings of fact and conclusions of law.

Findings of Facts

All questions involved in this case have been settled by admissions in the pleadings and stipulations of the parties, other than the question set out in paragraph numbered 1 in the order made upon the pre-trial conference herein, which is quoted herewith.

"That in view of the ruling of the Supreme Court in Commissioner v. Hansen, 360 U.S. 446 [3 AFTR 2d 1690], the critical issue in this case for determination is whether the plaintiff so kept its accounts of income for the years 1955 and 1956 so as to properly and clearly reflect the income of the plaintiff for the respective years by reporting its income upon a cash basis, or whether in order to clearly reflect the income the Commissioner was justified in requiring that

plaintiff's computation of its income be made upon an accrual basis for each of the years, and thereby include the funds herein involved as accrued income for the years 1955 and 1956 respectively."

In the stipulation of facts we find section VIII thereof to read as follows:

[1] "The only issues presented are whether taxpayer kept its books and records on the accrual basis and, if not, whether taxpayer, in order to clearly reflect its income, should have filed its federal tax returns on the accrual basis."

The plaintiff herein kept its books on a cash basis and on credit or sales on the deferred payment plan, they were negotiated, consummated and financed in accordance with a fixed pattern. The plaintiff as dealer agreed with its customer upon a cash delivered price for a particular vehicle owned by the dealer. In part payment of that price the customer made a down payment to the dealer in cash or trade in or both. To the remaining balance of that cash price there is added the cost of insurance on the vehicle and a finance charge. A negotiable promissory note was then prepared in the total amount of the unpaid purchase price, insurance premiums and finance charges. This note was made payable to the Claiborne County Bank, Tazewell, Tennessee, payable in monthly installments and the Dalton & Ely Motor Company, Inc., indorsed this note for the borrower, its customer. The note when signed and indorsed, was delivered to the bank. The bank then paid to Dalton & Ely Motor Company, Inc., all that part of the note representing

the purchase price of the car, so, that at the time the note was handled by the bank for the borrower, Dalton & Ely Motor Company, Inc., got the entire purchase price of the car. Monies included in the note for insurance premiums were paid by the bank to the insurance agency writing the insurance. When the installment payments were made by the borrower, part of the finance charge was kept by the bank for the use of its money and the other part was credited to the reserve account of Dalton & Ely Motor Company, Inc., with the proviso that none of this money was to be turned over to Dalton & Ely Motor Company, Inc., until the reserve account reached the sum of $30,000.00. The account never grew to that size. It was understood that the bank would charge to this so called reserve account, losses sustained by it on the paper it took from the customers of the plaintiff herein. Plaintiff was required to make collections from the makers of the notes, run them down and see too, to enforcing collections when necessary.

The court finds that the Internal Revenue Service made the plaintiff change its returns for the years of 1955 and 1956 from the cash basis to the accrual basis and in the year of 1955 it accrued as additional income the sum of $8,897.67 dealers reserve account and $1,761.50 of accounts receivable. For the year 1956 it accrued as additional income the sum of $12,045.11 dealers reserve account and $5.20 as accounts receivable.

It is stipulated that in the year of 1956 the sum of $3,004.87 was additional income for that year.

On January 27, 1958 the plaintiff paid the entire amount of the additional tax assessed in the sum of $7,144.55.

Conclusions of Law

The sum of $8,987.63 accrued as dealers reserve account in the year of 1955, and the sum of $9,040.24 accrued as dealers reserve account in the year of 1956, were improperly, erroneously and illegally accrued as income, and the tax collected thereon was erroneously and illegally collected. The plaintiff did not get possession of this money and it did not acquire a fixed right to the money, and none of it was income.

It is now directed that judgment be entered in accordance with these findings. Now, therefore, by reason of the law and finding aforesaid:

It is hereby ordered, adjudged and decreed:

That the plaintiff, Dalton & Ely Motor Company, Inc., have judgment against the defendant, United States of America, in the sum of $5,379.36 with interest thereon at the rate of 6% per annum from January 24, 1958 until paid.

That plaintiff have judgment against the defendant for its cost herein.

Smith Motors, Inc.

v.

U.S.

U.S. District Court, Dist. of Vt.,

No. 2947. August 8, 1961.

Years 1954-1956. Decision for taxpayer.

1. *Tax Accounting—Time for reporting income—accrual method—contingent right to receive income.*

Carrying charges credited under a used car sales contract at time of installment sale were not includible in income in year of sale by accrual basis seller. Here, if the buyer paid his obligation in a shorter time than contracted for, further "carrying charges" would be eliminated. Accordingly, if that occurred, taxpayer would never have a right to receive that part of the carrying charges paid early. That part would never accrue. To report the entire credit charge as income in the year of sale under the circumstances would be erroneous. Here the initial credit represented the total carrying charge of each transaction. When each installment of the carrying charge became due, the credit account was reduced by the monthly installment carrying charge. This carrying charge reduction was treated as income, whether it was received or not. This method was used by the taxpayer-corporation as well as by its predecessor proprietorship. There has been no change in accounting method. Under the circumstances, this method clearly reflects taxpayer's income. *Reference:* 1961 P-H Fed. ¶ 6120.

A. Pearley Feen, Burlington, Vt., Atty. for Plaintiff.

Joseph F. Radigan, U.S. Atty., Rutland, Vt., and Richard W. Perkins, Dept. of Justice, Washington 25, D.C., Attys. for Defendants.

Statement of the Case, Findings of Fact, Conclusions of Law and Judgment Order

Statement of the Case

GIBSON, District Judge:

This case is a suit for the recovery of alleged overpayments of income taxes for the taxable years 1954, 1955 and 1956, plus interest. On May 8, 1959, the Commissioner of Internal Revenue assessed income tax deficiencies against the plaintiff for the stated years. Payment of the deficiency assessments was made on May 26, 1959. Claims for refunds were filed on August 18, 1959, and these were disallowed on March 9, 1960. Suit was instituted under 28 U.S.C. Sec. 1340(a)(1) on March 5, 1960 after six months had expired since the filing of the claims for refunds.

Findings of Fact

1. The plaintiff is a Vermont corporation which has its principal place of business in Rutland, Vermont, and is engaged in buying, selling, trading and financing automobiles.

2. For some years prior to April 1, 1953, the business now carried on by the plaintiff was owned by Stewart A. Smith and was a proprietorship known as Smith Motors.

3. On April 1, 1953, the plaintiff corporation was organized as a Vermont corporation.

4. The corporation acquired the proprietorship in a tax-free exchange and the corporation thereafter operated the business formerly conducted by the proprietorship.

5. When the corporation was organized it took over an account carried on the books of the proprietorship which was entitled "Unearned Finance". This account had a balance of $26,281.96 on that date. The credit balance of this account showed the following increases over the balance at the close of the preceding fiscal year.

Fiscal year ended	*Increase*
March 31, 1954	$ 9,028.80
March 31, 1955	11,607.46
March 31, 1956	8,272.62

6. The predecessor proprietorship reported his income upon an accrual basis and his financial records included an "Unearned Finance" account. The credits to this finance account were not included in his taxable income in tax returns filed by him prior to April 1, 1953, but charges, either accrued or paid, were included as taxable income.

7. The corporation's method of operations included the financing of certain conditional sales of cars and trucks. The corporation obtained a "Used Car Contract" and "Conditional Sale Agreement" in all cases which involved credit sales.

8. On the "Used Car Contract" there was set out separately an item entitled "Carrying Charges" of a specific sum per month for a specific number of months. The number of months inserted in the blank provided in the Conditional Sale Note was the same number of months and amount as included in the "Used Car Contract". The contract provided that if the vehicle was paid for in full within the specified time period, a discount of the amount of the carrying charge per month would be allowed for the number of months paid in advance.

9. The initial credits to the "Unearned Finance" account represented the total "carrying charge" of each transaction as it occurred. The proprietorship and the successor corporation did not include these credits in taxable income. When each installment of "carrying charge" became due, whether such installment was paid or not, the "Unearned Finance" account was reduced by the amount of the monthly "carrying charge" and the reduction was treated as income.

10. This method was used by both the proprietorship and the corporation.

11. The "Unearned Finance" account was increased as sales occurred. It was reduced by "carrying charges" as they accrued whether paid or unpaid. Both the paid and unpaid monthly "carrying charges" were added to income as they accrued and were reported by the plaintiff as income.

12. The "carrying charges" included in the "Used Car Contract" terminated at the election of the Vendee

by payment of the balance then due. When such repayment was made the "carrying charges" were eliminated as an obligation of the Vendee to the plaintiff.

13. The income tax deficiencies here in question arose from a determination by the District Director of Internal Revenue at Burlington, Vermont, that the increases in the "Unearned Finance" account were taxable income to the corporation in the years indicated and in addition from a determination that the opening balance of $26,281.96 of this account, carried by the proprietorship and taken over by the corporation, represented taxable income to the corporation for its fiscal year ending March 31, 1954 and March 31, 1955. In its recent brief, the Government has conceded that the opening balance of $26,281.96 should not have been included as income.

Conclusions of Law

1. The statutory provisions determining the question involved are Sections 446 and 451 of the Internal Revenue Code of 1954 and Sections 41 and 42 of the Internal Revenue Code of 1939 as amended.

2. Taxable income shall be computed under the method of accounting under which the taxpayer regularly computes his income unless the method used does not clearly reflect his income. 26 U.S.C. Sec. 446(a) and (b). Section 41, Internal Revenue Code of 1939 as amended.

3. This is not a case in which the taxpayer has tried to change its system of accounting and in which it would be subject to the wide discretion of the Com-

missioner to reject a change. Brown v. Helvering 1934, 291 US 193, 204 [13 AFTR 851], 54 S. Ct. 856. 78 L. Ed. 725.

[1] This is a case where the taxpayer has consistently used the accrual method of accounting, both as a proprietorship and as a corporation. Where a taxpayer keeps his books and files his returns on an accrual basis, income is accounted for in the year in which the amount is earned or becomes fixed irrespective of when payment is ultimately received. U.S. v. Harmon, 205 F.2d 919 [44 AFTR 232]. This taxpayer followed this method.

4. The method used here by the taxpayer clearly reflected his income. If he had reported as income the total possible carrying charges at the time of the sale, his taxable income would be distorted. The reason for that this is if a purchaser were to pay the entire amount due for the vehicle purchased in a shorter time than called for by the contract, the taxpayer would be reporting as income, carrying charges not only that never would be received but that never accrued. Therefore, under the method adhered to by the Commissioner, the taxpayer would be required to report as income earnings that never accrued as the carrying charge in each particular month would never accrue or become earned until the completion of that pay period. By reporting the entire amount of carrying charges at the time of the sale, the taxpayer's income would be erroneous. Bressner Radio, Inc. v. Commissioner of Internal Revenue, 267 F.2d 520 [3 AFTR 2d 1530].

It is only where the right to receive a definite and exact amount becomes fixed should it be included in gross income. Here, if a purchaser pays his obligation in a shorter period than contracted for, the taxpayer would never have the right to receive that part of the carrying charges which is paid early. Therefore that part would never accrue.

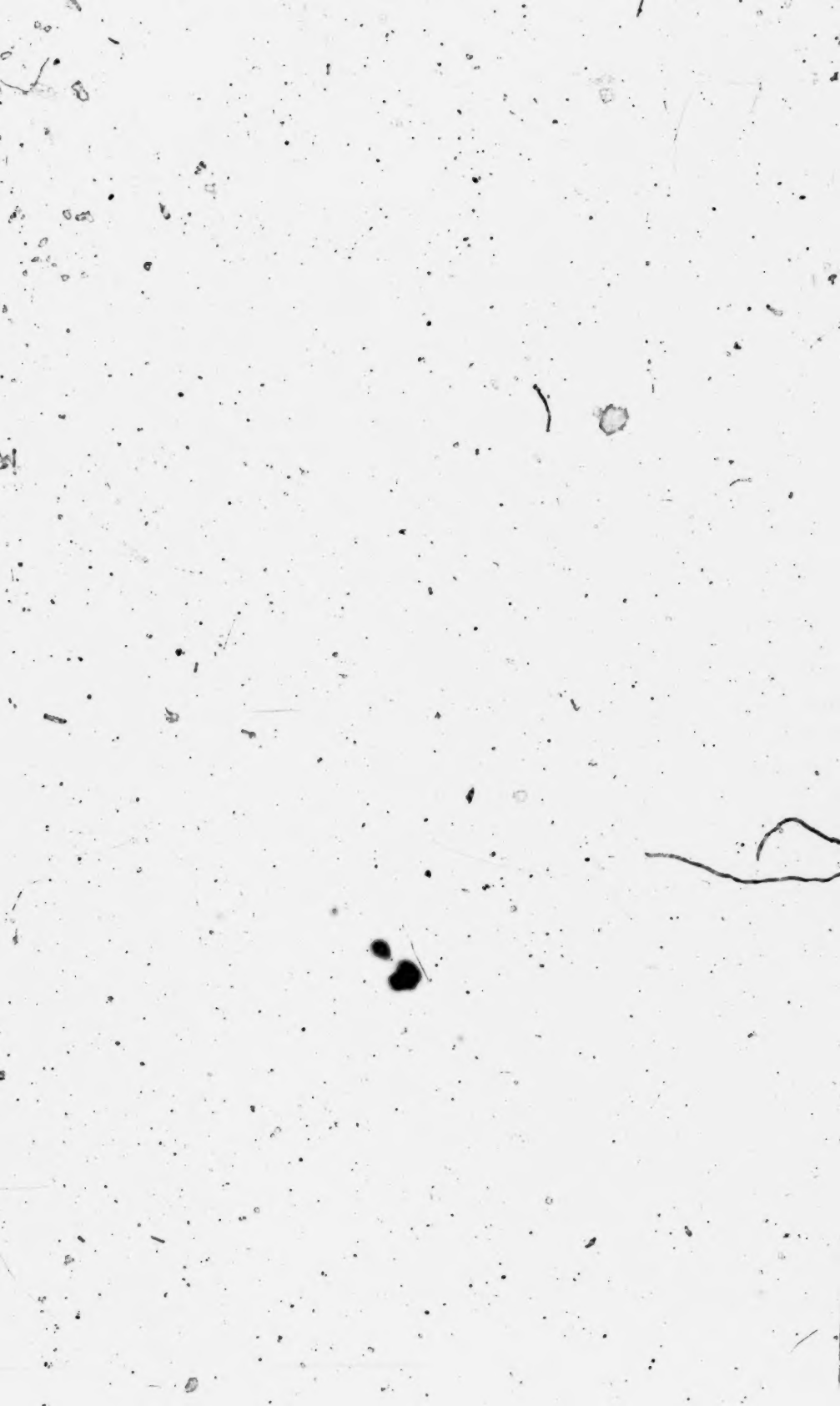
5. The Government in its brief argued that the recent case of American Automobile Association v. United States —U.S. — [17 AFTR 2d 1618], 6 L. Ed. 2d 1109, 81 S. Ct. 1727, overruled the Bressner case, supra. Again the American Automobile Association case dealt with the problem of the taxpayer's receiving the annual dues at one time and then allocating them over a specified period. The Court held that the annual dues which members of the association pay in full in advance at various times throughout the calendar year constitute income in the calendar year of actual receipt. There the taxpayer is positive that it will receive this income, while in the present case, the factual situation is totally different as has been outlined above and is clearly distinguishable from the case so heavily relied on by the Government.

6. Moreover, the Government in its brief agrees with the taxpayer that it was erroneous to include in its income the opening balance of the "Unearned Finance" account, taken over by the taxpayer corporation from its predecessor. The Government showed by its concession that it believed the taxpayer's method was correct until the corporation succeeded the proprietorship. There has been no change in the taxpayer's

method of accounting since the corporation acquired the enterprise. This Court feels that the taxpayer's method of accounting clearly reflected its income both as a proprietorship and as a corporation.

Judgment Order

It is hereby Ordered that the United States of America return the overpayment of taxes paid by Smith Motors Inc. plus interest and costs thereon, as computed by the Government, all in accordance with the views expressed herein. If such repayment is not computed and completed within 30 days, this Court reserves the right to make the computation and to enter a money judgment.



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No. 652

In the Supreme Court of the United States

OCTOBER TERM, 1961

E. E. R. SHAPIRO AND RUBYE SHAPIRO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 143–161) are not officially reported. The opinion of the Court of Appeals (Pet. App. v–viii) is reported at 295 F. 2d 306.

JURISDICTION

The judgment of the Court of Appeals was entered on September 7, 1961. (Pet. App. ix.) A timely petition for rehearing was denied on October 13, 1961. (Pet. App. x.) The petition for a writ of certiorari was filed on January 9, 1962. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

The accrual basis taxpayer sold used automobiles on credit and sold his conditional sales contracts to a finance company, receiving in exchange both cash and credits to a reserve account in its name on the books of the finance company. The question is whether the entire amounts credited on the books of the finance company, including payments for the right to receive finance charges, were taxable income to the taxpayer in the year when credited.

STATUTE AND REGULATIONS INVOLVED

The relevant portions of Sections 41 and 42(a) of the Internal Revenue Code of 1939 and of Section 29.41–1 of Treasury Regulations 111 (1939 Code) are set forth in the Appendix, *infra*, pp. 8–9.

STATEMENT

The accrual basis taxpayer[1] sold used automobiles on credit. Conditional sales contracts covering these dealings showed separately the amount due on the cash selling price, the cost of insurance premiums, registration and title fees, and the finance charges or the "time price differential." The time price differential was any figure to which the taxpayer could get the customer to agree. These contracts were sold to Pacific Finance Company (hereinafter referred to as Pacific). When Pacific bought a contract it paid the taxpayer an amount in cash equal to the face amount of the contract exclusive of the finance charges. Ad-

[1] E. E. R. Shapiro is referred to herein as the taxpayer. His wife is a petitioner since all of the income in the taxable years was community income.

ditionally, it credited to taxpayer's "dealer['s] reserve account" on its books an amount equal to the finance charges less a $7.50 handling charge and less the interest charged by the finance company.

The "dealer's reserve account" set up by Pacific secured the taxpayer's guaranty of the contract payments and its other liabilities to Pacific. Partial payment of the amounts credited to the dealer's reserve account was made to the taxpayer when, in the judgment of Pacific, the reserve was larger than necessary to meet the requirements of the guaranty. The taxpayer was beneficially entitled to all amounts credited to the reserve, subject only to his liabilities to Pacific. (R. 158.)

During the taxable years involved, the taxpayer included in income, and reported, only the sums actually received from Pacific in cash. (R. 155.) The Tax Court held that the amounts credited to the dealer's reserve account were accruable and taxable to the taxpayer in the year in which they were credited. (R. 159.) The Court of Appeals affirmed. (Pet. App. v–viii.)

ARGUMENT

1. The decision below is correct; there is no conflict in decisions; nor is there any other reason warranting further review. The Court below correctly applied the controlling principles set forth in *Commissioner* v. *Hansen*, 360 U.S. 446,[2] albeit to a vary-

[2] See also *United States* v. *Hine Pontiac*, 360 U.S. 715; *United States* v. *Colonial Chevrolet Corp.*, 360 U.S. 716; *General Gas Corp.* v. *Commissioner*, 293 F. 2d 35 (C.A. 5th), petition for certiorari pending, No. 633, this Term; *Morgan* v.

ing factual situation as to which this Court expressly declined comment in *Hansen*. In that case, as here, it was contended that the dealer need not accrue finance charges credited to the dealer's reserve account until those charges were earned by the finance company. While this Court in *Hansen* declined to pass upon the contention—holding only that the taxpayers had "wholly failed to sustain the burden of showing that any part of the amounts credited on the books of the finance companies to the respective Dealers Reserve Accounts was entitled to special treatment"[3]—the principles which it announced have been correctly applied by a number of courts of appeals to sustain accrual of the entire amounts credited to dealers' reserves, including portions attributable to finance charges. *Morgan* v. *Commissioner*, 277 F. 2d 152 (C.A. 9th); *Wiley* v. *Commissioner*, 266 F. 2d 48 (C.A. 6th), certiorari denied, 361 U.S. 831; *General Gas Corp.* v. *Commissioner*, 293 F. 2d 35 (C.A. 5th), petition for certiorari pending, No. 633 this Term.

There is no basis for distinguishing between portions of a dealer's reserve representing payments for the right to receive (a) finance charges from the retail customer and (b) the cash sale price. Whatever distinct identity each may have had as an obligation of the customer to the dealer was lost, so far as the dealer is concerned, when he exchanged it for the undifferentiated obligation of the finance company. The time of accrual as to either category is determined by the nature of the obligation the dealer receives from the

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Commissioner, 277 F. 2d 152 (C.A. 9th); and *Wiley* v. *Commissioner*, 266 F. 2d 48 (C.A. 6th), certiorari denied, 361 U.S. 831.

[3] 360 U.S. 446, 469.

finance company and not by the nature of the obligation the dealer sells to the finance company. After the taxpayer-dealer in the instant case sold the right to receive finance charges from his customer, he no longer had a right to receive anything in the nature of interest for the use of his money over a period of time; and although the finance company received interest payments from the retail purchaser, the taxpayer-dealer, who had lent nothing to the finance company, did not receive interest payments from that company. He received, rather, an immediately accruable obligation of the finance company to pay "the full amount of the contract balance, less its discount consisting of its specific charge and a percentage of the total contract balance." (Pet. App. iv.)

There is no merit in the contention (Pet. 10–11) that the possibility of a loss of some part of the time price differential (by prepayment or by default on contracts) forecloses accruability of the amounts credited to the dealer's reserve. The possible diminution of Pacific's obligation to the taxpayer in the event of prepayment or default by the retail purchasers is nothing more than the consequence of conditions subsequent to the taxpayer's present and fixed right eventually to receive the total amounts credited to him in the dealer's reserve account (either in cash or by offset of his obligations to Pacific against the amounts credited to the reserve account). (R. 146.) In *Morgan* v. *Commissioner*, *supra*, it was held that the diminution of a reserve because of prepayment did not affect accruability; and, as the court below pointed out (Pet. App. vii), the proportionate debiting of reserves in both the *Hansen* and *Morgan* cases,

supra, upon default by purchasers did not impair accruability.

Nor, as the taxpayer suggests (Pet. 9, 12, 14–15), are *Hansen* and *Wiley, supra*, inapplicable here simply because Pacific reserved to itself full discretion as to when payments from the dealer's reserve were to be made to the taxpayer. As the Court below properly observed (Pet. App. viii), "when the reserve exceeded the amount of taxpayers' liabilities, direct and contingent, the excess was payable" and "[i]f there was uncertainty as to the time when taxpayer was entitled to payment, it resulted not from any question as to his right to the reserve but from the existence of counterbalancing direct and contingent liabilities."

The asserted conflict with the district court decision in *Dalton & Ely Motor Co.* v. *United States* (E.D. Ky.), decided on July 10, 1961, and now pending on appeal to the Sixth Circuit, is plainly no basis for certiorari.[4]

[4] The other district court decision claimed to be in conflict—*Smith Motors, Inc.* v. *United States* (D. Vt.), decided August 8, 1961—involved the accruability of finance charges by a dealer who held his own paper and did not, as here, sell it to a finance company.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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LOUIS F. OBERDORFER,
Assistant Attorney General,
MEYER ROTHWACKS,
CAROLYN R. JUST,
Attorneys.

MARCH 1962.

APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under

section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111 (1939 Code):

SEC. 29.41–1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42–1 to 29.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

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